

U.S. Assistance Strategy for Ukraine 1999 - 2002

Executive Summary

Ukraine's success in making the transition to a democratic society and market economy cannot be overstated in its importance to U.S. national interests. A strong, stable, independent, prosperous, and democratic Ukraine will be an important partner in tackling post-Cold War problems such as proliferation, expanding commercial and economic relations, and shaping a more secure and stable Europe. Such a Ukraine will elevate its status as a more equal neighbor to Russia. A weak and destabilized Ukraine, however, would be a debilitated partner of the U.S. and the West.

The U.S. assistance program has two overarching and mutually supportive objectives; it seeks to (1) help Ukraine realize its potential in building a strong, independent, democratic, and economically viable country by increasing its self-reliance, and (2) further Ukraine's effort to integrate into the global community and forge stronger ties with the West. To succeed in these objectives Ukraine must make the transition to a market economy and democratic society. The U.S. assistance priorities over the next four years, the period of this strategy document, will help Ukraine to: (1) promote economic growth by setting in place an environment conducive to investment, empowering people and groups to have greater control of their lives, facilitating job creation, transforming important sectors of the economy, and easing the pain of the transition; (2) consolidate the institutions of a functional democracy through civil society and a society based on the rule of law; and (3) improve the quality of life for Ukrainians by addressing, for example, reform in health care delivery.

The euphoria that greeted independent Ukraine in 1991 has subsided. The G7 countries anticipated, and expected, a quick and thorough destruction of Ukraine's Soviet past, but expectations were overly ambitious and greatly exceeded what could realistically be done. After seven years, Ukraine, with the support of the donor community, has accomplished much and its transformation to a democratic state may well be irreversible. However, the current economic and social situation could threaten to overturn progress made in its transition. Despite some progress in economic reform, most observers agree Ukraine has not made the tough, but necessary policy reforms done more successfully by its Central European neighbors (e.g., Poland, the Czech Republic, Hungary). The transformation process will take much longer than anticipated and U.S. assistance will continue to play an important role into the next century.

The G7 countries and the donor community have learned invaluable lessons during this period. First, government in Ukraine is not a monolithic structure; senior officials hold adamant and often divergent views on the shaping of post-communist Ukraine. In Ukraine where the parliament has significant (if not nearly equal) power relative to the executive branch, political stalemates frequently occur and block change. Moreover, a

class of elites who have benefited from turmoil and a chaotic transition has evolved - a group which is reluctant to endorse change that would disadvantage its economic interests. This class has the power to influence politicians at senior levels and with this influence has obstructed progress in the transformation process. Second, the donors have learned that the problems for countries in transition are unique and complex. Lack of political will does not fully account for lack of progress. Western experts hold neither precise nor clear remedies for Ukraine's troubles.

Moreover a financial crisis has spread westward from Russia and threatens to undermine Ukraine's economy. Though the financial crisis appears to offer the Government few practicable alternatives other than to pursue reform in earnest, deeply entrenched interests and populist tendencies may counter the Government's pursuit of reform policies over the next several years, especially in the heat of the upcoming presidential election campaign.

In the past, much attention and a significant share of assistance resources were channeled toward the central government's reform efforts. This has had less of an impact than had been hoped. Over the period of the strategy, the U.S. assistance program will proceed along three major paths to bolster U.S. assistance objectives. First, empowerment of people, both economic and political, will become a stronger theme. A mix of governmental and extra-governmental support will continue; but the preponderant share of resources will be directed toward grass-roots and empowerment programs dispersed throughout Ukraine, such as strengthening pro-reform, advocacy NGOs, helping progressive local governments evolve into responsive and institutionally capable administrative units, and supporting an entrepreneurial spirit (through such means as teaching business skills). However, we expect to encounter a number of obstacles. The list of obstacles includes a population that is largely cynical about reform (given the poor results to date) and apathetic toward participation in citizens' groups; local governments that are ineptly managed, irregularly financed from the central government, and often corrupt; and a pernicious national legal environment that impedes entrepreneurship and self-initiative.

A second focus of the assistance program will stress greater involvement of senior U.S. policymakers in the reform policy dialog through bilateral discussions with Ukrainian counterparts, e.g., the Gore-Kuchma Commission, and through U.S. participation in the multilateral funding institutions. In a crisis, opportunities for positive change arise, and the present financial crisis offers such an opportunity. But more effective means must be found to ensure that the donors' collective dialog with the government leads to real change in the most important areas of structural reform (e.g., public administration reform, privatization, and deregulation), not simply compliance with the letter of conditionalities.

A third track will press for reform through technical assistance to implement the conditions of the recently-approved IMF Extended Fund Facility (EFF) and the conditions of the structural adjustment loans and other loans of the World Bank. The policies sought after under these programs conform to the policy reform framework of the

USG, and are essentially the preconditions identified in the Partnership and Cooperation Agreement Ukraine signed with the European Union (EU) in March 1997. By meeting these preconditions Ukraine will advance its efforts in developing a special partnership arrangement with the EU. Moreover, without financial and structural reform, the economy and political system could collapse. U.S. assistance will be applied selectively to crucial reform efforts of the national government and where tangible progress is taking place.

Changes in Program Direction

This strategy does not propose a great departure from the evolving strategy of the past few years¹. There are notable changes, however. First, programs at the local level will gain more prominence. Our experience with local leaders and governments has shown that many want to improve services to their citizens through better infrastructure or adopting a facilitative business environment. As an example, many cities and municipalities are seeking U.S. assistance in privatizing commercial land as a way to generate revenues for local governments and to spark increased investment. Their receptivity is high; their capacity to implement reforms is low. We believe technical assistance can make a difference in those cities and municipalities that embrace reform-oriented ideas and policies.

Second, assistance programs that touch people directly, immediately, and tangibly will become a priority. These include not only local infrastructure activities, such as improvements in public transportation, but also programs that help people take control of their destiny. Major policy reform efforts at the national level have failed to take hold and so the expected benefits of those policies have not trickled down to most Ukrainians. Even in the absence of an enabling economic policy environment, there are market-reform programs that have a high probability of success. The small business initiative is one such program, which will remain a high priority. In agriculture, a new approach will be taken, one that promotes empowerment by working with private farmers and owners of garden plots in selected, progressive regions in Ukraine.

A third change is that the assistance strategy will place greater importance on programs that help develop a civil society in Ukraine. Recent efforts have shown some remarkable results with citizens' groups taking on government and winning. An expansion in our advocacy support programs will try to capitalize on these successes by pressuring the "top" from "below" on national policy changes. The assistance programs will encourage and support indigenous think tanks and NGOs throughout the country to challenge government so that advocates for reform throughout Ukraine keep the reform dialog on the agenda of Government.

¹ However, if one were to compare the assistance program of five years ago with that of today, one would conclude there is considerable change. (The assistance program of five years ago was heavily weighted toward central government-led reforms.) Change in the program has come in increments.

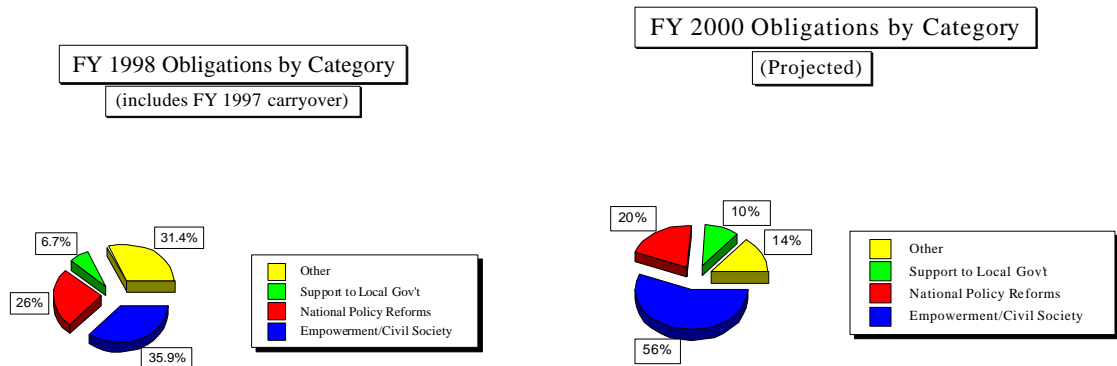
Fourth, policy work at the national level, though vitally important for Ukraine's survival in the short-term and economic growth over the longer term, will have a tighter concentration with most assistance tied in to support "leveraged" reform; that is, the policy conditionalities of the EFF and the World Bank's loans. In instances where initiatives at the local level or empowerment programs, such as small business, may become stymied by the absence of national policies (or by bad policies), we will engage the national government on a selective basis when it appears the chances for success are high and where strong constituencies for change exist.

Other shifts follow. Programs in health care will have a strong strategic coherence with the theme of improving health through a greater reliance on primary and preventive care. New initiatives will begin to combat corruption in society, which, among other things, is a major impediment to investment. In the energy sector, U.S. assistance programs will move away from restructuring efforts and begin to pave the way for outright privatization of both generators and distributors of power.

The USG will bring to a close its mass privatization operations, having achieved many of the program's goals, although limited initial support for cash privatization of the largest government-held industries may continue. Restructuring support of the newly privatized companies will begin as a follow-on program.

New special programs will start over the next four years: a regional development initiative in Kharkiv will be undertaken; Poland-Ukraine ties (and ties with other reforming Central European countries) will be strengthened through programs funded by the U.S.; the fight against trafficking of women into prostitution abroad will intensify; and programs that address global climate change will commence.

(Given the directions outlined above, USG assistance will likely assume the form shown in Graph 2 below. Last fiscal year's funding is shown in Graph 1 for comparison.)



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Forecast

Ukraine will likely not change fundamentally in the short to medium term. Change will come in increments, some positive, others not so, over the next several generations. U.S. assistance will help ensure that economic reform takes place in step with strengthening democratic processes. If economic reform were implemented by fiat, for example, those reforms adopted would likely benefit few, be largely incomplete, and create more public discord on reform issues. Adopting democratic values would make the change process more transparent, durable, and inclusive, though slower. Demographic factors also suggest Ukraine's transition will move slowly and incrementally. Ukraine, a country of more than 50 million persons, has 15 million pensioners, 5 million government workers, and another 3 million who work for state-owned enterprises -- nearly half the population is dependent on state relief or support. Together they form a very strong bloc who resist a retreat from socialist values.

Unless Ukraine abandons its reform effort completely and provided the global economic slump of 1998 improves, we expect Ukraine will eventually begin to experience a gradual rise in GDP in the latter part of this four-year Strategy. Social issues, such as health care and pension reform, will begin to be addressed, but little reform in those sectors will have occurred. Some of the more progressive local governments will have pursued and succeeded in adopting experimental and innovative reforms in land privatization, infrastructure, and agriculture. NGOs will have become more active (some self-sustaining), and more influential in changing public policy.

The USG should set its aims high, but keep its expectations realistic. One of the more valuable contributions the U.S. assistance program can make over the next four years is to help create the many building blocks of reform through institutional strengthening both inside and outside government, and help advance those national reform efforts the GOU would be willing to pursue (for example, moving from a Soviet accounting system to international accounting standards). This would allow a Ukrainian government with serious reform intentions to consolidate these "building blocks" into a comprehensive reform program, thus shortening the time of the transition. Another valuable contribution will be the wider planting of "seeds" for reform throughout the country. The program will build on the successful practices developed over the past five years at sub-national levels. Finally, the assistance program will also keep the reform debate alive in Ukraine by supporting advocacy NGOs and reform elements within the Government itself (and at the local government level), thereby preserving progress made to date and preventing a retreat back to a Soviet model of governance.

The U.S. assistance strategy must remain flexible to respond to opportunities and to disengage from failing initiatives.

Ukraine's Problems

Since independence the quality of life in Ukraine has been on a steep decline. Though statistics must be viewed with caution (e.g., they fail to capture the unofficial economy in full), they paint a grim picture. GDP has fallen by about 55 percent (with eight consecutive years of GDP contraction), agricultural production by 60 percent, and industry by 57 percent. Infant mortality has increased from 12.8 per 1,000 births in 1990 to 14.3 in 1996; life expectancy has dropped by an average of more than 2.5 years from 1991 through 1996 years (for men the decline is even more notable, average life expectancy has diminished by more than 3 years from 64.7 years in 1991 to 61.6 years in 1997); and those who have fallen below the poverty line now number between 16 and 26 million persons – one-third to one-half of the population. Official unemployment is growing and the unofficial, but more realistic, reports conclude that 4 out of every 10 Ukrainians are either unemployed or under-employed. One example of measuring this decline in living standards is UNDP's Human Development Index, which examines gross indicators such as real GDP *per capita* (PPP basis), adult literacy, life expectancy, and education enrollment rates. *The 1998 Ukraine Human Development Report* shows Ukraine's index rating slipping once again. Ukraine has fallen from 95th place, as reported in the 1997 report, to 102nd, well below Belarus, and, according to the study, on par with Uzbekistan, and Albania.

After seven years of independence, Ukraine's democracy is still fragile, though several national-level elections have taken place, including the first elected change of presidents in the NIS. The latest round of parliamentary elections in March 1998 was declared largely free and fair by most international observers, with the Communists winning the greatest number of seats in the Ukrainian Parliament (the '*Rada*').

However, the media find themselves under the influence of government. Interest groups tied to political leaders have arguably taken control of most of the larger media organizations. This became most visible during the parliamentary elections and is expected to be more of a problem as presidential political campaigns get underway for the 1999 elections. Media groups that report unfavorable stories have felt pressure, been threatened, and even abused by those directly or indirectly implicated in their reports.

Moreover, a civil society, one in which groups outside of government make their voices known and have influence over policy decisions, is largely underdeveloped, though more than 3,000 active non-governmental organizations (NGOs) exist. The executive branch holds control over the judiciary branch, with court decisions often reflections of the desires of influential politicians and other leaders.

The specifics may be unique, but in general similar problems and underlying causes persist throughout the countries of the former Soviet Union (NIS). All have shared the full brunt of the seventy-four years of Soviet rule and must dismantle former systems and restructure new economic and governing systems - overwhelming and complex tasks.

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According to studies², Ukraine's uneven experience in reform is similar to the experience of other NIS countries.

Underlying Causes

Independent Ukraine has built its current system of government upon the foundation of the old Soviet system. The present system is an eclectic and incoherent mix of organizations inherited from the Soviets and others formed since independence. It is inefficient, largely non-responsive to the needs of the people, corrupt, and ingrained with the philosophy (again a legacy of the past) that government should control, not facilitate and regulate, society and the economy.

The Government is not responsive to the needs of the people and the present structure does not allow for accountability. Public opinion surveys indicate that an overwhelming majority of Ukrainians feels powerless over its ability to influence change and therefore remains disengaged from public policy issues. In a survey conducted in fall 1998, approximately 87 percent of Ukrainians polled said they do not belong to any civic or political organization. This absence of public pressure on the government has done little to inspire leadership at the top levels in Government. Only recently, when faced with an impending financial crisis, has President Kuchma been engaged in economic reforms.

Decisions involving economic resources are not optimal. Government subsidies, though decreasing, are still passed down to dinosaur industries that have no market for their products. Corruption flourishes in the current environment; the continuing presence of Government in all aspects of the economy has spawned corrupt practices and rent-seeking behavior.³ Policies and actions of the government tend to protect entrenched interests. Despite recognition by many in government that change in the way Government operates is necessary, the vested interests in the present chaotic situation will cause change to proceed slowly and unevenly.

A third problem is that even if there were consensus on change, Ukraine at this stage lacks the capacity to do so. Few people in and outside government understand the global environment and the realm of possibilities. Many supporters of reform speak the language of market economics, but few comprehend it. Moreover, schools and universities still turn out graduates who are ill-prepared for work in a modern economy. Few teachers and professors understand the requirements of a democratic society and market economy.

² See *Nations in Transit 1997*, Freedom House, and *Transition Report 1997*, EBRD.

³ Corruption *per se* does not necessarily inhibit investment (foreign or domestic) as long as it is predictable and not too onerous. Southeast Asia was used as an example where corruption and growing investment coexist. However, studies on corruption in the NIS and Ukraine in particular show that corruption or required payoffs are unpredictable and detrimental to the survival of business. A senior World Bank representative recently termed the behavior of rent-seekers in Ukraine as "acid-stripping" of businesses.

Major Events Influencing the Pace of Reform

Over the next four years, two major events will profoundly influence the direction Ukraine takes. The financial crisis is an immediate and mid-term challenge for the Government of Ukraine, which potentially threatens the stability and solvency of the country for at least the next eighteen months and most likely beyond that. In 1999, Ukrainians will return to the polls and elect a president. As the elections draw nearer to the poll date set for October 31, 1999, the Government is less likely to pursue reforms that could require short-term socio-economic sacrifices on the part of the population, even if necessary for longer-term growth, and certainly one could expect it to be totally averse to proposing fundamental reform. Reforms will continue in 1999 and beyond, in our view, but probably only to the extent that they keep the tap open to World Bank and IMF disbursements, or respond to some perceived political advantage.

The financial crisis in Ukraine results directly from the structure of the Government's debt, and the spread of the Asian crisis contagion westward to Russia and now Ukraine; and fundamentally from a lack of progress in putting into place structural reforms necessary for a market economy to thrive. Starting in late 1996, the Ukrainian Government began to finance its large deficit through short-term, high-yield treasury bills. At first attractive to non-residents, as the crisis in Southeast Asia worsened and as government failed to restructure its economy, foreign investors grew wary and began leaving the market. Longer-term foreign currency loans or bonds became increasingly difficult to obtain and, for those agreements concluded, interest rates continued to rise. The government quickly built a debt pyramid it could not repay.

To remain solvent, Ukraine must convince the donors and the world's financial institutions that its situation is not as precarious as Russia's and that it is serious about reforming. To backslide on its reform program will result in a cut-off from much-needed donor financing, and signal to investors that the Ukrainian market is still not a viable place for investment. From an outsider's view, Ukraine has no other choice than to implement the tough structural reform policies it has agreed to do. However, our experience in persuading the Government to undertake economic reforms leads us to believe that Ukraine will not aggressively pursue reform and will likely do what is minimally expected in order to meet IMF and World Bank targets.

The assistance strategy will also be affected by the presidential elections scheduled for October 1999. The pace and shape of reforms throughout 1999 will be largely influenced by the election campaign, and, in 2000 and beyond, by the outcome of the elections.

Although President Kuchma and the Speaker of Parliament have claimed that relations have improved between the two branches of power, Kuchma's critics from across the political spectrum are as vocal as ever. Certainly, Kuchma will continue to be vulnerable to criticism that his administration is responsible for the country's economic malaise over the past four years. This popular sentiment may embolden the parliament to oppose any attempts by Kuchma to implement his economic reform programs, as it has already done by rejecting some recent presidential decrees. Whereas some opposition parties may

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oppose Kuchma's reform efforts for ideological reasons, even reform parties may find it politically expedient to withhold support for Kuchma's decrees. Indeed, certain reforms, such as reducing subsidies, raising the retirement age, or closing down bankrupt enterprises, would be difficult to implement in an election year in any country. The president may feel compelled to implement populist measures that are counter to the reform agenda, such as abandoning its strict monetary policy in order to pay off wage arrears. There are several reasons, therefore, why the period leading up to the presidential elections may be devoid of significant reforms, as was generally the case prior to the March 1998 parliamentary elections.

Another effect of the presidential election campaign in 1999 may be an erosion of political, personal, and press freedoms. The 1998 parliamentary elections witnessed significant abuses of political power by the government in using coercion and manipulation to restrict press freedoms and prevent a fair playing field for all candidates. Given such abuses during the parliamentary elections, such tendencies would likely be even greater in 1999 when the stakes are much higher. If this is the case, it will be a setback for democratic reforms, and will undoubtedly have political reverberations internationally.

Given the economic environment and elections, three possible scenarios emerge. First, the crisis in Russia, only now beginning to be felt in Ukraine, will motivate the government into action and strengthen the hands of reformers. Conversely, the backward-looking elements, which still wield considerable power, may cite the Russia example perversely by explaining this is what happens when Western reforms are blindly adopted. A policy of re-nationalization in important sectors, something being given serious consideration in Russia, may appeal to this group. A more likely scenario, and one consistent with past experience, is that Ukraine will muddle through this, barely doing enough to qualify for monthly IMF and World Bank disbursements.

Approaches

The donor community as a group has concluded that after seven years of providing assistance to Ukraine, its collective approaches have not succeeded in fundamentally changing the policy environment. Studies consistently show that technical advice to governments which do not fully commit themselves to undertaking reform policies show little measurable effect. In the preceding months, the donor community has begun to take stock of its efforts in Ukraine. The World Bank country assistance review in Ukraine, as an example, promises to be a thorough examination of what has worked well and what has not. Without prejudicing the outcome of this evaluation, the Bank will likely conclude that the operating environment for the private sector is no better than it was five years ago. This is a condemning statement not only of the Government's reform and development efforts, but also of the donor community's ability to influence change at the national level.

In discussing in general what approaches U.S. assistance programs should take over the next four years, it is important to consider certain realistic assumptions. First, the financial crisis in Ukraine will continue for at least eighteen months, or longer if Ukraine continues to muddle its way through. Second, the working relationship between the executive and legislative branches will improve only slightly from the gridlock of the last four years, and will likely worsen during the run-up to the presidential elections. There will continue to be no consensus on how far reform should be taken, or what specific reforms should be implemented. A further problem is that the Government's capacity to implement reform will weaken as the fiscal crunch and the public administration reform efforts result in, at least initially, the Government's having many fewer workers with fewer resources at their disposal. This will occur without the necessary structural changes taking place in Government (such as redefining the role of government) that could improve efficiency and cut costs. Third, financial desperation will not be limited solely to the central government; as expenditures are slashed the amount of remittances to local governments will decline precipitously, forcing crises at the local levels. Innovation and assistance to reform-minded groups at the local level will be key to keeping many local governments afloat.

Given an environment in which decision-makers are not expected to adopt deep reform measures before or after the October 1999 elections, the USG advocates an approach that continues to push for top-level, structural reforms with a national impact in this period of crisis (where such efforts prove to be effective), while at the same time places greater emphasis on the longer term by working to prepare the next generation or perhaps the generation after for coming to power. The spill-over effects from Russia have already had a tangible impact on the Ukrainian economy -- the banking system finds itself in a state of crisis and exports to Russia have begun to drop -- and U.S. assistance programs should be directed toward helping Ukraine avoid an economic collapse.

In general the assistance program will look for more effective ways to effect change in the short and long run, including longer-term efforts to support change from the bottom up. Under each of the priority areas articulated in the section below is a detailed description of what approaches we expect to take over the next four years, but in general they are:

Policy Reform Dialog: At this point the G-7 countries and the multi-lateral funding institutions hold a tremendous amount of leverage over influencing the shape of Ukraine's economic policies. The two groups should speak with one voice (and consistent strategies) in pushing the government for even greater structural change in the economy as they continue their discussions with the Ukrainian government. The USG should recommend to the World Bank that it lead a consultative group meeting on Ukraine to arrive at agreement on a donors' strategy. USG senior policy-makers should make clear to Ukraine that funding for top-down programs will continue only in response to tangible signs of reform. The U.S. should use its influence at the World Bank and the IMF to press for thorough reviews of conditionality before agreements are made to disburse funds.

Structural reform programs should include enough flexibility to prevent instances where the Government meets the letter of the law of a structural adjustment loan, but contradicts the intent of the reform program by instituting backsliding policies. The Agriculture Sector Adjustment Loan of the World Bank is an example where the letter of the law may have been met, but the spirit was so badly violated that little change or reform will result in the agricultural sector. The USG position must be firm in preventing premature disbursements since the pluses in doing so are short term only.

Selected Support for Effective Government Reform Efforts: The general view is that the structural adjustment loans of the World Bank overlaid on top of the EFF make an effective reform program for the immediate financial crisis as well as for the longer term. The U.S. assistance program should continue to help support the enactment, and more important, the actual implementation of these critical reforms unless there are signs of backtracking and/or disbursements under the IMF and Bank programs are suspended.

Longer-term Approaches: An error committed by the USG and other donor countries was the supposition early on that reform could happen rapidly. It hasn't in Ukraine, or anywhere else in the NIS. The USG and other donors must come to the realization that we should be prepared to stay engaged in Ukraine's transition and development for the long haul. This will allow experimentation with new approaches including:

Demonstration Activities: Commitment to change comes when one has evidence that it leads to something better. One of the weaknesses in Ukraine's transition is that people in general are not aware of the universe of possibilities. They cannot articulate the changes they want, therefore their advocacy policies are ineffective. Demonstration projects would raise the expectations of people to a higher level. For example, a health care facility that provides reliable, relevant, and high quality services for a fee (one not much higher than the unofficial fee patients must pay now to get services) shows people (including those in local government) what is realistic and possible. Greater reliance on partnerships with U.S. organizations will help leverage our assistance dollars further and promote binding ties between the U.S. and Ukrainian organizations.

Pro-Reform NGOs and Think Tanks: A number of NGO leaders and think tanks have successfully linked up with pro-reform elements in Government and have had a surprising amount of influence over the direction the Government has taken on certain reforms. The U.S. assistance program will give greater attention to helping make these NGOs and think tanks sustainable and educate them on how to maintain independence (and thus protect their credibility), yet help direct and influence public policy making.

Empowerment of people will become a cornerstone of USG assistance efforts. Getting people to believe in themselves, to rely less on government to guide their daily lives, and to take control of their destiny through economic opportunities and political choices will form the foundation of the assistance program.

Pilot Testing of Reform Initiatives: In areas important to the overall transition and where reform has been blocked, the assistance program will begin to develop local pilot efforts in selected progressive *oblasts* and *raions*.

Draw on Lessons Learned from Central Europe, with Attention to the Polish Experience: Poland and other Central European states have made the transition to a market economy and democratic society in relatively short periods of time. The reasons for an accelerated transition are many and varied, but there are valuable lessons that can be applied from their experiences in helping Ukraine move forward. Moreover, a U.S. foreign policy objective is to promote stronger Poland-Ukraine linkages. Through the Poland-America-Ukraine Cooperative Initiative (PAUCI), the U.S. will continue to support assistance to Ukraine using Polish expertise. Although this cooperation is taking place in all sectors and in many areas of the country, PAUCI will initially focus on macroeconomic support, local government capacity building, and small business development.

Reforms and Advocacy: A stronger connection between proposed reforms and those who will benefit from them needs to be made. For reforms that are important for the overall change process and which have stalled or are under debate, the U.S. assistance program will make a concerted effort to identify groups that benefit from the proposed reform and work with them to make their voices heard.

Greater Support to Reduce the Potential for Corruption: Support for anti-corruption measures will play a more prominent role in U.S. assistance programs. One theme that will run through many of our programs will be to reduce the potential for corruption by encouraging transparent measures (for example, public hearings on local budgets), reducing regulation (and thereby reducing the number of potential rent-seekers), and putting into place incentives/disincentives to reduce corruption.

Study Tours: Ignorance of how the world market economy and democratic countries operate has constricted understanding of available options. Study tours to the U.S. and Central European countries, particularly Poland, will open the eyes of up-and-coming reformers.

Framework for an Assistance Strategy

There are no simple solutions to Ukraine's difficulties, and no simple formula for effective assistance. Regional trends are important and instructive. A strategy for assistance to Ukraine must take account of the recent financial crisis and political reversal in Russia and the reassessment that has resulted in the U.S. and elsewhere of the disappointing progress in economic and political reform in the former Soviet Union. That reassessment is not over and there are many points of view; it appears, however, that expectations for future economic and political reforms will be scaled back, and that the outside world is bracing itself for a much longer period for positive reform and change. It also appears the donors will place greater emphasis on strengthening domestic institutions and pro-reform constituencies that will, over time, support change from within. What, then, is the appropriate strategy for assisting Ukraine?

For the long-term, the USG can and will encourage the development of constituencies that will press for economic reform and a more civil society from within. We can and will work at a grass roots level to improve the lives of individuals and build a civil society from below. But the effects will be felt only over an undefined "long term" and local level interventions can, in many cases, be neutralized or even reversed, by the actions and decisions from above. If the state undergoes financial and/or political collapse in the meantime, the long-term picture itself is uncertain.

In the short term, a Russian-style reversal is quite possible. Though Ukraine is not Russia's mirror image, the parallels and connections (e.g., trade) between the two countries are extensive and deep. Ukrainians say when Russia sneezes Ukraine catches cold. Our interpretation is that structural economic reforms in Russia slowed dramatically in 1996 (and were largely incomplete) and did not, as a result, establish the base for sustained growth. Resource revenues and external financing postponed the day of reckoning but did not prevent a collapse from happening.

Ukraine faces similar and perhaps deeper risks. Its immediate financial condition is not as dire. In certain areas (curbing inflation and rationalizing communal services pricing, among others) Ukraine has reformed more than Russia. But in just as many areas, reform has been less. Ukraine lacks natural resource revenues to cover its mistakes. And there may be even less political leadership for reform than in Russia. There appears to be no force in Ukraine, other than donor pressure, strong enough to put in place the structural reforms required setting growth in motion and sustaining it. Without growth, it may only be a matter of time before a Russian-style collapse happens here.

For the short term, therefore, there appears to be few alternatives to more effective donor action to encourage and support the most fundamental economic reforms. However, we are deeply concerned that Ukraine and the donor community have already started down the Russian path. It is deeply disturbing, for example, that international loans are moving forward when Ukraine has yet to offer a majority stake in an attractive state enterprise to a real strategic investor. It is equally troubling that our own efforts in policy reform

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dialog are failing to effect fundamental reforms in key sectors. No strategy for long-term assistance to Ukraine is viable without a more effective mechanism between donors and the Government to assure fundamental economic change. This strategy, therefore, proposes a multi-track approach:

- C reduced expectations about what can reasonably be accomplished -- but not below levels required to prevent a collapse;
- C a tougher position on conditionalities for international loans combined with continued technical assistance to support implementation of structural reforms, but only where reform is clearly moving forward;
- C focused assistance on programs, such as small business development, that can empower people economically and awaken them from political apathy;
- C and, a long-term effort to establish and strengthen individuals and institutions that will support the development of civil society from within.

USAID Priorities

The U.S. assistance strategy over the next four years will continue to concentrate its efforts in: (1) **Promoting Economic Growth**; (2) **Developing a Functional Democracy**; and (3) **Improving the Quality of Life for Ukrainians**. The sections below lay out objectives and approaches in each of these three areas.

I. Promoting Economic Growth

❖ A. Improve the Environment to Encourage Investment

Ukraine can continue to exist as a viable independent country only if it is financially solvent. A market-oriented economy also requires a minimally acceptable environment for both domestic and foreign investment. Without the ability for business to operate legally and a legal system that permits non-governmental organizations, assistance efforts at the grass-roots would be less effective. These conditions are barely met at the current time and the low level of new private investment in the recorded economy is evidence of the weaknesses in the investment climate.

Ukraine possesses abundant natural and human resources and a relatively well-developed, though deteriorating physical infrastructure. The institutional infrastructure necessary for a well-functioning, market-oriented, private sector-led economy is extremely weak, however. To remedy the situation USAID plans to continue its efforts to establish and strengthen these necessary systems:

- a financial system;
- a budgetary and tax system;
- a regulatory and commercial law system; and
- a less corrupt system of public administration.

Financial System

The sad events in several Asian countries and most recently in Russia dramatize all too clearly the critical role of the financial sector in economic growth and stability. Ukraine, like other transitional countries has started very much from the beginning in developing institutional mechanisms to support financial sector markets (banking, fixed-income and equity). Equally important, there is no experience from the former system in developing a business culture based upon market norms. This is because of the limited and sharply circumscribed role of financial markets under the former Communist system. For example, banks were no more than funnels for centrally determined investment plans.

During the first years of Ukrainian independence hyperinflation took its toll on the banking system and discouraged the public from entrusting banks with their savings. Thus, the most important tasks in building a market based banking system in Ukraine are a) to foster public confidence in the banking system; and b) to improve the banking sector's capacity to promote economic development through the market-based allocation of financial resources. Similar challenges confront the corporate securities market, which has had even less time to develop than the banking system -- public share ownership only began when Ukraine started its privatization program in 1995.

Banking: After six years of independence the contours of a market-based banking system are beginning to form. Nonetheless, many fundamentals of the former centrally-planned Communist economy do not die easily. Some prevalent practices of the Ukrainian banking system, such as lending to insiders and related parties, as well as the continuing (albeit much reduced) directed lending by the banks at the government's behest violate the development of a market-based banking system. It is still also the case that building blocks of the supporting financial infrastructure -- the government's regulatory apparatus and the legal underpinnings -- are quite undeveloped.

Moreover, because the fundamental infrastructure is weak, and at the same time Ukraine is rapidly integrating into international financial markets, there is increasingly a danger of a systemic banking crisis, impacting good banks as well as bad banks. As we have seen in many countries, this could adversely impact the economy and jeopardize Ukraine's fragile economy recovery.

Thus, the role of technical assistance from USAID is clear. The priorities will be to :

- C **Develop the financial infrastructure** -- the legal and regulatory framework in order to ensure transparency and sufficient regulatory bite (which will, among other things minimize corruption) in the development of these untested markets. This includes, most importantly, government oversight through its bank supervision function and a legal infrastructure reflecting market-based operation methods.

- C **Promote commercial bank upgrading.** Human capital development through training is fundamental and central. This is needed, along with the realignment of incentives, to cultivate a culture within the banking sector to adopt best practices. A banking culture must develop; one that places a premium upon prudent banking and risk management, coupled with appropriate corporate governance.

Corporate Securities: The financial crisis in the region makes development of an open, transparent and safe corporate securities market in Ukraine more important than ever if domestic business is to grow, employ resources and people effectively, and to help Ukraine avoid the collapse other economies in the region have suffered. A lesson the countries most affected by the regional and global financial crisis have learned is that highly leveraged economies and companies are the most vulnerable. Capital markets are also important to facilitate changes in ownership following mass privatization and to facilitate restructuring that new owners bring. They are important as a channel for direct and indirect foreign investment. In the longer term, the institutions and practices of a developed market for savings and investment in corporate equity are essential to mobilize domestic capital, including the all-important future pension systems of Ukraine, for productive domestic investment.

USAID's strategy for the next four years will aim to establish the institutions and practices for open, transparent, and safe equity investment. It will combine partnerships between USAID and private institutions in the market (ultimately leading to independent partnerships between those institutions and similar ones in the region and United States) with continued support to the Corporate Governance Task Force and Ukraine's Securities Commission as long as they continue to move effectively in the direction of openness, transparency, and impartiality. The emphasis in working with the Commission will be to establish the missing key laws and implementing procedures, strengthen the delegation of self-regulatory authority to private parties, and improve enforcement particularly of shareholder rights and corporate governance.

Partnerships will be strengthened with private market institutions including the PFTS, a privately-owned central depository, the Ukrainian Association of Registrars (PARC), and an anticipated association of collective investment firms such as mutual or pension funds. The nature of the partnerships will vary between organizations and over time but will be characterized by the development of democratic governance by and for members; professional standards and practices of self-regulation; expanded advisory services to members; a gradual transition from TA-intensive support to grant relationships between USAID and the private partner; and support for exchanges and establishment of ongoing, independent links between these private groups in Ukraine and successful counterparts in the U.S. and the region. Development of a central depository will represent the only "hard" activity during the period and should be complete during the year 2000. Here too, however, as the success of the PFTS has shown, successful institution-building will be the key and will depend largely, in turn, on establishing predictable and consistent, open and democratic governance by members and users.

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Fiscal System

The transition to a market economy within a democratic political system requires fundamental changes in the size and scope of Ukraine's public sector and consequently in the macroeconomic policies that the government pursues and the fiscal framework in which it operates. Ukraine has been slow to make this transition and consequently it continues to suffer economic decline. Tax revenues fall short of projections; reliance on barter rather than cash transactions is growing; budgets provide for unrealistic levels of social spending; public employment and subsidies to failing state-owned enterprises and thus arrears are mounting; local governments are starved for funds; and the costs of financing the deficit have crowded out all other financing for the economy.

The priorities for USAID technical assistance are to:

Restructure the tax system to encourage economic activity and taxpayer compliance, and ensure fair and consistent application of the laws. This involves assistance directed at modernizing the tax laws to reduce the burden on private enterprise, broadening the taxpayer base and shrinking the shadow economy, and introducing more sophisticated and less coercive tax administration techniques.

Improve the budget process to ensure realistic and transparent budgets that comply with IMF targets and World Bank loan conditions. This requires a process where revenues are reasonably estimated, expenditures conservatively forecast, spending priorities are set in line with clear and consistent policy directives, and budgets executed as approved by Parliament. Technical assistance must be directed at improving budget preparation and execution, including development of a clear budget classification and budget system law and analytic techniques to promote efficient use of resources.

Over the 1999-2002 period, USAID fiscal reform programs will continue to be closely coordinated with both the International Monetary Fund (IMF) and World Bank to ensure that technical assistance supports the fulfillment of conditions for receipt of their loans. Increasing emphasis will be placed on measures to improve the financial condition of local governments and strengthen their autonomy and accountability. These will include efforts to broaden the revenue base of local governments, mainly through development of a real property tax system, and pilot projects in reform-oriented local and/or regional governments to introduce reforms in tax administration and budget policy.

Legal and Regulatory System

A successful market economy requires a legal framework to support basic economic freedoms, the guarantee of private property rights, and the means to enforce these rights. The primary underpinnings of a commercial law system include structures for property ownership and transfer, for market entry and exit, and for market competition, as well as

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cross-cutting laws on taxation, banking, and labor. The lack of Ukrainian experience in market principles and parliamentary process has made it extremely difficult to establish a sound commercial law framework in Ukraine. However, the basis for changing this situation is beginning to be laid. A modern Constitution was adopted in June 1996. This was the most fundamental step toward establishing the rule of law and, therefore, a stable basis for commercial law. The civil code, which forms the foundation of private law, is the next fundamental structural requirement. A modern civil code passed its first reading in the Rada in June 1997.

Notwithstanding these improvements, there remains, not without merit, a broad perception of instability in the legal infrastructure. This perception is particularly prevalent in the international community doing business here, and is a strong impediment to private and foreign investment. Many of the reported problems relate to the lack of predictability of the legal system (of policies, legislation, enforcement of judgments), as well as a control mentality and excessive regulation. Concerns are also based on government corruption as well as an unstable system with excessive measures on collection.

Technical assistance should support development of a legal and regulatory framework conducive to increased private investment. This assistance complements related efforts addressed elsewhere in this strategy (e.g., legal efforts related to the banking, capital markets, and fiscal programs). There are three key premises upon which the program is built: 1) any legislative drafting must be Ukrainian-led; 2) it is essential to concentrate assistance not just on legal drafting, but also on building an understanding of, and constituency for, the objectives of the law; and 3) ensuring that mechanisms are in place to implement the law fully once enacted. Over the next four years, the USG assistance program will continue to pursue legal reforms in three principle areas:

- C Regulatory Reform - remove barriers to starting new businesses, barriers to investment, and barriers to business operations at both the national level with the State Committee on Entrepreneurship Development and at the local level in selected oblasts
- C Bankruptcy/Financial Restructuring - passage and implementation of a modern bankruptcy law that would allow for both creditor and debtor led restructuring and implementation of a financial restructuring program that would roll out results of local pilot activities
- C Collateral Law - implementation of a collateral registry for movable property to support secured lending accessible nationwide through commercial banks and notaries

Other foci could include programs to promote confidence in the judicial system and confidence in the enforceability of contracts. A more comprehensive approach will be taken to address capacity building needs in the areas of drafting, training, and information dissemination. Pending the passage of the Civil Code, new initiatives will address areas

that remove and relieve critical bottlenecks to investment or that add the legal infrastructure to support investment.

Public Administration

The public administration system in Ukraine requires fundamental changes to meet the needs of a market economy within a democratic political system. As presently constituted, the policy decision-making process lacks clarity, transparency, and effectiveness. The GOU has made a commitment, in conjunction with the pending World Bank Public Administration Reform Structural Adjustment Loan, to implement comprehensive reforms in public administration at the central and, eventually, local levels. The expected reforms include reducing the number of ministries, defining clear lines of authority, reforming the central Apparatus, and creating a civil service system. The hoped-for result will be a fundamental change in the philosophy of government in Ukraine toward a Western-style government.

USG priorities include:

- Functional review and restructuring of the Ministries of Finance and Economy. Fiscal policy in Ukraine, and USAID's fiscal reform programs, are greatly affected by the fragmentation of fiscal policy responsibilities among different GOU entities, including these two ministries and the recently formed State Tax Administration, among others. The functional review provides a potential means of achieving a better organization of fiscal responsibilities within the GOU.
- Assistance with functional review and restructuring of other GOU ministries: USAID is also involved with public administration reform in key sectoral areas in which it is engaged, such as agriculture and energy, in order to improve the effectiveness of the policy process and promote economic reforms.
- Over the 1999-2002 period, USAID activities in the area of public administration reform will continue to be closely coordinated with both the International Monetary Fund (IMF) and World Bank to ensure that technical assistance supports the fulfillment of conditions for receipt of their loans.

❖ B. Promote Job Creation

Private businesses form the foundation of a market economy and its largest source of employment and income. Transition to a market economy in Ukraine requires that private business growth begin rapidly. But the condition of private business in Ukraine today is of major concern. Little restructuring is taking place among former state-owned companies. The largest 200 enterprises have not yet been privatized and account for a disproportionately large share of the total labor force. The approach being used to begin privatizing them threatens to diffuse ownership needlessly and delay restructuring, and/or to preserve sufficient government shares to discourage true strategic investors. Because

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the investment environment also discourages significant "greenfield" investment, large enterprise in Ukraine is largely restricted to large privatized firms which are, for the most part, not doing well. The overall picture is thus a discouraging one, with up to 50% of the workforce employed - or underemployed - in ex-state enterprises that have not yet adapted to a competitive market environment.

Small business is in better, but still not good, condition. Some 45,000 small enterprises have been privatized. Figures on new startups are not reliable but, for two reasons, are partly bound to privatization: without a well developed real estate market, the premises of privatized small enterprises are a common site for new "piggyback" enterprises to begin; privatization of unfinished construction sites is gaining momentum and appears to be becoming a second launching pad for new business. Ukraine's success in privatizing small business is a good start. But small business nevertheless has a long way to go -- it is said to account for less than 10% of total employment as compared to 20% in Russia and 45-50% in Eastern Europe.

The much larger employment contribution of small business in other countries of the region suggests that small business development, by itself, could have significant impact in Ukraine even if other reforms are not undertaken. This is only partly true. Small and medium enterprises (SMEs), like large ones, cannot grow in a hostile policy environment. Worldwide, SMEs are most numerous when they grow together with large enterprises -- as suppliers of parts and services, as distributors, and so on.

This suggests a more complex strategy that combines addressing key policy constraints, a vigorous small development business program, and measures to encourage the turnaround or winding up of privatized large enterprises.

Policy interventions are essential for small, and large, business to grow in Ukraine. Some are particularly important for larger enterprises. The method of privatization for example -- i.e., offering controlling stakes through internationally acceptable competitive methods -- will largely determine the fate of Ukraine's largest enterprises. Tax deductions for training or re-training employees would encourage large ex-state enterprises to restructure as would further liberalization of the propiska system to facilitate labor mobility. Bankruptcy procedures are particularly important to encourage troubled firms to restructure or wind up operations.

The most fundamental policy changes that are needed affect both small and large businesses. An example is developing a tax system that not only assesses fair rates but is also applied to internationally accepted accounts that accurately reflect profit and loss.

Other policies are more specific to small business. Simplified accounting procedures, for example, and easy business registration processes, are particularly important. Deregulation may have a disproportionate effect on small business. Frequent and irregular inspections by government officials affect small businesses, most of which cannot afford to pay the arbitrary fees charged by these officials. This rent-seeking

behavior by government officials significantly inhibits business growth since it reduces the capital that small businesses have to plow back into business growth activities. Larger enterprises can better insulate themselves from this type of behavior either through political connections or more sophisticated accounting and management techniques.

We anticipate direct involvement in some but not all of these policy areas. Provided there is will and progress from the GOU side, USAID will continue to work on the tax system, bankruptcy procedures, administrative reform, the introduction of IAS, and deregulation. In other key areas such as privatization of large enterprises, among others, U.S. involvement will be largely through donor dialog. These are so essential to the larger objective of enterprise development, that a strong U.S. stance will be critical.

Other support for enterprise development during the period of the strategy will involve USAID in direct relationships with private enterprises and local governments. Though we do not plan major involvement with the restructuring of large enterprises, a steady course will be maintained in two areas. First, a modest enterprise restructuring project just launched will continue through the next several years to build local capacity to restructure local enterprises. Over time, this is expected to evolve into a process of dissemination of essential enterprise restructuring techniques through the media and business fora. Second, the privatization of land under enterprises is proving highly popular at the local government level and has not drawn political opposition nationally. We expect to roll this activity out such that it will be self-sustaining and need no further USAID support by the middle of the strategy period.

Small business development is expected to comprise the major thrust of the enterprise development effort, with policy and a limited large enterprise restructuring program in the background. Here too, USAID will work primarily directly with private parties and, in some cases, local government. Four components are already started. Each will evolve over the period. Direct support to 16 business service centers will decrease as they become self-sustaining and be replaced, by the middle of the strategy period, by a more systemic program to develop a resource center for the private consulting industry generally. These may include local law firms and accounting businesses as well as the current business management and training companies.

Development of the service and lobbying abilities of business associations is beginning and is focused on local and regional groupings of small and medium entrepreneurs. This will be a growing part of the small business program, will continue largely at the local level, and will complement grass-roots efforts to build local representative groups generally. Progress is likely to be gradual and will be determined largely by the ability of local entrepreneurs to find common cause with each other and to develop their own common institutions.

USG support for small business finance is just beginning but will also evolve. A small business lending program with the EBRD and local banks has started but faces a major challenge from the region's financial crisis just as it gets underway. Assuming the

challenge is met, our objective by the end of the strategy period would have the participating banks take over the program and lend their own funds. A complementary program, working with PVOs to make smaller loans to microenterprises, is also planned though faces a number of legal hurdles. Provided these are surmounted, it is expected that a Ukrainian NGO will commence a large-scale, nationwide microlending program (following a successful pilot phase). U.S. support for independent credit unions will continue at a modest but steady level. Other low-intensity efforts to address financing constraints of small business will be undertaken if and as opportunities arise and may include the promotion of leasing and franchising.

Finally, USAID will continue to work with local government till mid-2000 to privatize up to 10,000 unfinished construction sites. Each represents a new business opportunity. Though the program gets little attention in the national government, it is very popular with local governments, is moving quickly, and has started to show significant employment impact.

❖ C. Help Transform Important Sectors of the Economy

Agriculture

Despite many important changes in Ukrainian agriculture in the past few years, fundamental agricultural reform -- open marketing, private input supply and processing, and reduction of state involvement in the sector -- has not taken place. At the time of the break up of the Soviet Union and Ukrainian independence, considerable enthusiasm and optimism was generated over what fundamental changes could be made in Ukraine's agriculture sector. Expectations were proved to be unrealistic as both Ukrainians and the international donor community went through a learning curve finding out what, in fact, was realistic. As a result, major policy changes in agriculture will come in more of an evolutionary form and the expectations of the donor community, in their current form, will continue to be only partially met.

Elements of Strategic Change. The fundamental strategic change is to move from projects and programs focused heavily on policy sensitive areas at the central government level, to ones focused on private farmers and households where people benefit directly and at the same time the benefits of private, market-based agriculture can be demonstrated to the country and the people. Therefore, the agricultural strategy will move on two tracks:

First, will be a concentrated effort in 2-3 geographical locations where prospects for private farmer and household production and marketing improvements appear fairly high. These will be closely tied to and supportive of the USAID-supported Large Farm Restructuring and Land Titling program already underway. The objective will be to concentrate a major share of USAID's resources in a few locations where progress can be made, to improve conditions in those locations, and to demonstrate to the country and the Government that private farming, household production and land privatization can

produce better results if supported by effective marketing, input supply, extension, and credit services.

Second, a reduced but highly focused effort will be maintained at the central level to bring about fundamental policy reform in agriculture. Despite the difficulties encountered in the past two years, there *is* an important element of support for reform in the country. The USG, as a strong force pushing for change, can both bolster that element and continue to keep this issue before the general public and Government. At the same time, by maintaining a channel of communication with national policy makers, the USG will have the opportunity to feed results of the regional “demonstration” activities into national policy discussions. Finally, the national efforts will complement the policy dialog of the Gore-Kuchma Commission, the World Bank, and other donors by providing analysis of major policy impediments in the agricultural sector. Benchmarks for the dialog component over the coming year include preparation and review with the GOU of analyses of land leasing, donor conditionalities, domestic support policies, tariff and non-tariff barriers, policy implications of WTO accession, and the political economy of Ukrainian rural society.

Energy and Other Infrastructure

The energy sector is one of the key parts of the economy, accounting for half of total imports and perhaps 20 percent of total output. It is essential to the survival (and resurrection) of the industrial sector, which is particularly energy-intensive, and essential to the survival of Ukraine as a modern, urbanized society. Energy production has been cut in half since independence, the physical infrastructure has deteriorated greatly and huge debts have accumulated. District heating is decentralized and barely meets the needs of the urban population due to poor maintenance and scarce supplies of fuel. The totally integrated power system, however, has been broken up into 35 generation, distribution and transmission companies, a regulatory mechanism has been established, and commercialization has increased. The coal sector has made little progress towards restructuring and continues to contract and deteriorate. Gas production has leveled off after a 30 year decline, though there is potential for increased production from conventional wells as well as from coal-bed methane.

Energy and infrastructure systems in Ukraine must evolve over the next 10 years if there is to be a successful sustainable economic, political, and social transition. The transition of the energy systems is particularly important given their central economic and political role under the communist system. Although the economic aspect is the most critical at this time, the overall societal transition will be suboptimal if the infrastructure systems are not transformed into open, competitive, decentralized commercial operations with substantial private sector involvement, sound autonomous economic regulation, minimal political intervention and substantial citizen participation. The systems include power, gas, telecommunications, water, and district heating.

The Mission strategy over the next four years would maintain the U.S. lead role by completing power sector reform, play a significant role in the gas sector reform, and transfer the successful approaches and lessons learned to initiate the systemic transition of the heating and water systems at the municipal level. The elements of the strategy are (1) legal and regulatory development at the national and local level; (2) sector restructuring, i.e., unbundling and decentralization of the monopoly systems; (3) preparation for commercial operation and privatization, including addressing low-income customer issues; and (4) improvement of fuel supply.

- **Legal and Regulatory Development.** USAID has been a lead TA provider to the National Electricity Regulatory Commission (NERC) in assuring a fair, transparent and predictable governance over the electric generation and supply market. Over the last 2 years NERC has become a well-recognized solid institution that issues licenses, regulates producer-and-consumer relationships and, more importantly, formulates a market-based tariff system. NERC has to develop its authority over oil and gas market operation and USAID assistance is key to implementing this reform. NERC also has oversight responsibility for district heating, which USAID is likely to address in later years, building on its experience in improving efficiency and working at the local government level. In addition, NERC now has to deal with issues related to legal and policy support for investment and the environment. U.S. experience in this area is invaluable, and needs to be transferred to Ukraine.

- **Energy Systems Operation: Unbundling, Commercialization and Privatization.** The experience of the last few years has shown that the industry only becomes efficient if it is properly unbundled in a timely manner, and is privatized while becoming commercially viable. In Ukraine the experience of privatizing 40% of distribution companies' assets by sale to financial investors is not likely to prove to be efficient. Implementation of a transparent process that is consistent with established world practices - including appointment of foreign advisors - should be a matter of high priority for the Government. In past years, the USG was not active in assisting the GOU in this aspect of the program. The USG, along with the World Bank and the donor community, considers that only privatization of power utilities by strategic long-term investors can bring new management and badly-needed capital and technologies. Gas sector neo-monopolization through creation of a holding company is also a concern on the part of donors, and the USG will work further with the Government to develop a strategic action plan for unbundling, and then transparent and non-discriminatory privatization.

- **Fuel Supply and Fuel Independence.** Work in the power sector has demonstrated the importance of fuel supply for an efficient, solvent power system. The fuels are natural gas and coal, and local production of both has been declining. Natural gas and coal-bed methane gas offer good prospects for increased supply. Coal production can be increased, or at least made more efficient through concentration on the better mines. USAID will work on these subjects primarily through its involvement with the power sector and NERC, although it will be open to other approaches that offer

significant prospects for success. Based on previous experience, this is likely to be through privatization and private sector development.

❖ D. Ease the Pain of the Transition

In Ukraine, as elsewhere in the former Soviet Union, the emergence of the "new poor" has erected one of the strongest barriers to further economic reforms. In 1994, as old social protection systems collapsed, Ukraine lacked the basic building blocks for a new social protection system.

- Support for social protection reform will be vital to ensuring that the new poor do not create an insuperable political barrier to reform as well as to alleviating the very real suffering of large numbers of the Ukrainian population.

In helping to ease the pain of a society stalled in the transition process, the USG will emphasize five areas over the next four years:

Completion of the System of Targeted Social Assistance

The success of USAID's support for the housing subsidy program has provided financial relief for many poor families as well as fiscal relief for the central government. Among the approximate 4 million households receiving housing subsidies, about 700,000 suffer severe economic privation – with per capita household income below 37 Hrn per month. Over the next four years the assistance program will assist the GOU in setting up a guaranteed minimum income program to assist these "poorest of the poor." This program will allow the elimination of many poorly targeted social assistance programs as well as laying the foundation for the elimination of privileges – which cost the State Budget an estimated 5 billion Hrn (larger than the current budget deficit projected for 1998).

Pension Reform

The failing state pension system poses the greatest fiscal threat to the State Budget. State pension payments account for 10 percent of Ukraine's GDP today. Although the state pension system is "off-budget," supplementary funds must be sought from the budget to meet the growing needs for 'social pensions' and to pay the growing arrears that now exceed \$1 billion. The solvency of the pension system, therefore, adversely affects Ukraine's overall fiscal position. With 14 million pensioners supported by about the same number of tax-paying workers, little can be done to improve the position of pensioners without major reforms. The major problems with the present system that reform must address include:

- Very low benefits paid to pensioners and invalids-- barely - 3/4 of the poverty level – and arrears of as long as eight months in paying pensions;
- The lack of correlation between contributions paid and benefits received; and
- The high rate of payroll taxes – 32.5% -- to support the state pension system.

The U.S. assistance program will continue to support pension reform as long as the Government maintains momentum in pursuing reform in this area. Future opportunities in pension reform include:

- Continued support for the improvement of the legislative framework;
- The creation of a national database of all pensioners to provide accurate management information, provide data for actuarial analysis, to allow auditing of pension expenditures, and reduced administrative costs;
- The creation of a nationwide database of all working Ukrainians (modeled on the SSA database in the U.S.) to improve collection of payroll contributions, eliminate workbooks, improve labor mobility, automate pension calculations, and allow auditing of all social protection programs.
- Development of a solid regulatory and sustainable financial structure for the private pension insurance and development of administrative systems required to support the private pension system. This includes personification of contributions, calculation of individual account balances, and production of employee statements.

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Limited Assistance to Labor Market Programs

The most difficult social problems in the transition from a planned economy to a capitalist free market economy is unemployment. Planned economies are monopolies with all the inefficiencies and waste and overstaffing normally associated with long established monopolies. As enterprises enter the competitive market place, the costs of inefficiency, waste, and overstaffing must be reduced or the enterprise will fail. The most obvious cost reduction target is overstaffing, which results in rising unemployment.

Because Ukraine entered the competitive economy cautiously, unneeded workers were placed on forced "administrative leave." They remain on the enterprise's records, but they are not working or paid and are ineligible for severance or unemployment insurance payments. Approximately 3 million Ukrainian workers are currently on administrative leave. Thus, the speed of restructuring in the Ukrainian economy and adjustments in the labor market can be measured by the labor hoarding indicator, defined as the difference between cumulative changes in employment and GDP. In Ukraine, the labor hoarding indicator was among the highest in the FSU - in 1991-1997, 44 percent (reported GDP declined by 54 percent and employment by 10 percent). This shows that restructuring of enterprises (and the whole economy in Ukraine) has been one of the least successful in the region.

The USG will provide limited assistance targeted to the creation of a regular labor market monitoring system (on a quarterly basis), based on household sample surveys, to allow the Government (and the donor community) to monitor and react to changes in the labor market.

Restructuring the Housing and Communal Services Sector

Despite tariff increases that have raised the rate of cost recovery for housing and utilities from 4 percent in 1994 to nearly 100 percent today, communal services to Ukrainian families have not improved. Unless the housing and communal services sector is restructured -- with reforms in accounting, tariff-setting procedures, management and finance -- services will continue to deteriorate, payments from households will decline, and, in the not-too-distant future, the system is likely to collapse completely -- threatening public health and welfare as well as strengthening opposition to reform. USG support will focus on the following types of technical assistance:

- National regulations and local pilot programs to implement Generally Accepted Accounting Standards for communal service enterprises in Ukraine;
- National guidelines and local pilot programs for tariff setting by oblast and local administrations;
- Reform of national regulations affecting communal services enterprises; and
- Pilot programs to demonstrate better management and technical procedures for providing services.

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Immediate Impact Programs

With over half of Ukraine's population living below the poverty line, what limited support there now is for reform will soon completely evaporate if measures are not taken to shelter the most vulnerable groups in society from falling incomes and the deterioration of basic public services. Ukrainian citizens cannot be expected to envision and aspire to a more promising future, when their present, immediate welfare is in such a precarious position. Strengthening NGOs that provide social benefits and services through training and other support mechanisms helps mend the tattered social nets which are so critical during periods of economic transition. Non-governmental organizations (NGOs) serving the elderly, disabled, disadvantaged children and other needy groups comprise nearly half of the 3,000 active NGOs in Ukraine (out of a total 18,000 NGOs registered), attesting to the fact that participatory democracy is taking root in Ukraine, although gradually and with many obstacles to overcome. Similarly, providing crucial humanitarian assistance, particularly in response to natural or man-made disasters, helps decrease the suffering of those in especially a crisis.

In its efforts to develop sustainable Ukrainian NGOs capable of providing social services to the most vulnerable Ukrainian citizens, the U.S. assistance program has incorporated strategies to address these concerns, and will continue to refine those strategies in future years. Under its Democratic Social Service NGO Program, the USG will continue to try to "cherry pick" existing NGOs that have a good community standing and a strong chance at survival. Those NGOs that survive will be, not only sources of inspiration, but tangible examples and sources of technical expertise that can be replicated elsewhere in Ukraine.

The USG will continue to offer support to Ukraine's emerging third sector in the form of both technical and financial help as it rises to the challenge of addressing the needs of its people. Through NGOs the USG provides competitively-awarded seed grants to Ukrainian NGOs serving social needs.

Another important aspect of USG assistance to social service NGOs will be the cost-share requirement in which NGOs match USAID seed grants with their own funding or in-kind contributions. NGOs are able to meet these conditions, usually by counting public support, such as volunteer labor, or in-kind contributions, such as government-provided office space. Under the current program, initial grants require 25 percent cost share; a second grant requires the level of cost share to rise to 40 percent. Future rounds of grants will further increase the cost share requirement. In this way, USAID will wean local NGOs off of donor assistance, but do so in a way that realistically assesses current economic conditions and increases the NGOs chances for survival.

Improving the legal and regulatory environment under which NGOs operate will continue to be an important part of USAID's program. The USAID-sponsored International Center for Not for Profit Law (ICNL) is focusing intensively on an analysis of the legal

environment and will be working with the NGO and donor communities to devise a strategy to achieve clarification in related areas of legislation such as the civil code and tax code.

At the same time, USAID also has provided humanitarian assistance through government social service agencies and local non-governmental organizations (NGOs) to meet the immediate critical needs of Ukraine's most vulnerable citizens. Since 1994, USAID's Community and Humanitarian Assistance Program (CHAP) has provided more than \$50 million worth of humanitarian aid to government social service institutions and local NGOs providing needed social services. In the last year alone, this program has provided approximately \$10 million worth of clothing, bedding, footwear, furniture and other humanitarian assistance to all 280 orphanages and boarding homes for the elderly and severely disabled under the Ministry of Social Protection. In addition to providing humanitarian support to government social service institutions, USAID provides humanitarian aid to the most needy through local social service NGOs. Since 1995, USAID has provided assistance to over 2 million needy Ukrainians distributed through more than 300 local NGOs.

In addition, an effective means of leveraging NGO Development support has been by providing humanitarian assistance through partner NGOs. This tactic helps boost the partner NGOs authority demonstrating the greater impact that can be achieved in the distribution of aid and the contribution to the sustainability of the organizations through more coordinated efforts.

II. Developing a Functional Democracy

Democratization, one of USAID's five strategic goals, is not only an end in itself. Indeed, stable democracies are less likely to go to war against each other, more likely to cooperate on issues of global security, and more likely to work cooperatively to avert natural and man-made crises. To these ends, democratization contributes to US foreign policy goals. Moreover, the correlation between democratization and long-term economic development is unmistakable, despite lack of consensus about causality in the relationship. In Ukraine, democratization contributes to economic development by providing the necessary legal foundation for economic reforms to be successful, promoting the development of a civil society that demands transparency and accountability in a hitherto largely corrupt and erratic reform process, and strengthening political institutions that support such democratic practices in a rule-of-law-based society.

Without sufficient political will at the top necessary to undertake broad-based economic reform, a democratic, rule-of-law-based society enables interest groups (both economic and political) and ordinary citizens to apply pressure for greater reform from 'below' on the 'top.' In other words, democratization supplies the 'demand' for further economic reforms when the political establishment is unable or unwilling to otherwise 'supply' reforms unilaterally. The current *status quo* of partial reforms has allowed elite and

powerful interest groups to greatly profit from the lack of transparency, competitiveness, and enforcement of contracts, while the majority has been unable, or sometimes simply unwilling, to demand changes. The result has been that most Ukrainians have been unable to benefit from political and economic reforms. Furthermore, many Ukrainians have come to oppose reforms in general because 'reforms' have led to a lower quality of life for them.

Less than 10 years ago Ukraine lacked an independent media, independent courts, mechanisms to uphold the rights of citizens, freedom of association, free and fair elections, free access to information, adequate legislation to support economic reforms and local government autonomy and authority, and other basic institutions and processes upon which a democracy is built. Furthermore, Ukraine lacked individuals with experience, education, or training in the skills necessary to establish the fundamentals of a democratic society. Still, Ukraine has made significant strides in its democratic transition. In 1994, Ukraine was the first post-Soviet state to implement a peaceful transfer of presidential power following free and fair elections. In 1996, the adoption of the Constitution and the subsequent establishment of the Constitutional Court provided Ukraine with the basis for all adopting and implementing reform legislation. The Law on Local Self Governments, passed in 1997, gave localities more powers and responsibilities, including direct control over municipal services. Since 1991 the number of non-governmental organizations has grown from a handful to more than 3,000 active organizations. Non-government newspapers now compete with government newspapers. Thousands of Ukrainians, including judges, journalists, attorneys, newspaper managers, political party activists, NGO leaders, civic activists, legislative drafters, municipal government leaders, law faculty, and trade union leaders, have put into practice knowledge received from Western trainers and advisors.

Nonetheless, the progress made has been nominal when compared to the work that remains to be done. Ukraine still lacks basic legislation, such as civil and criminal codes, necessary for reforms to be effective. The judicial branch has not yet been established as a viable, independent branch of government because politicians still influence judges by controlling court financing and benefits for judges. Political pressure, censorship, government media monopolies, inadequate legislation, difficulties defending press freedoms in the courts, and other problems stifle Independent media. Local governments are hampered by unclear divisions of fiscal responsibility and systems of delegation between oblast and local level governments, in addition to revenue shortfalls and inadequate fiscal autonomy. Key legislation must still be passed and implemented to more firmly establish autonomous local governments and to encourage democratic practices at the level most accessible to citizens. The worsening economic situation makes it difficult for non-government media and organizations (NGOs) to become financially self-sustaining. NGOs find it difficult to enlist public support in their efforts due to government resistance to include them in public-policy debates, and citizen apathy and lack of understanding about the roles of NGOs. Even where legislation is clear, political processes are often conducted behind closed doors, and individual rights ignored. For example, journalists and citizens often find it impossible to obtain

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information that is supposed to be open to the public, and citizens' rights are often ignored due to lack of knowledge of the laws or lack of access to legal representation. Elections have been administered more-or-less freely, but, arguably, unfairly, and with the exception of the nationalist Ruche party, there are no reform-oriented political parties with recognizable platforms or broad-based grass-roots support.

Approaches for promoting democratization in Ukraine, therefore, should focus on three areas that address the problems described above: promoting the development of the rule of law; strengthening civil society (i.e., participation in political and economic processes by informed and responsible citizens); and promoting efforts at the local level to strengthen legislative and fiscal authority and autonomy, and to implement reforms which are stalled and/or less effective at the national level.

❖ A. Promote the Development of Rule of Law

As noted above, the establishment of a rule of law based society is essential to the success of economic and political reforms. Overcoming the institutional and social-psychological legacy of the Communist past in order to erect a legal system that supports free-market democracy is a formidable undertaking. In order to establish the rule of law and legal systems that better support democratic and economic reforms in Ukraine, it is necessary for (1) the Courts to carry out their legally-mandated role, (2) an appropriate legislative framework to be drafted and enacted, (3) citizens to hold government accountable to the law, and (4) judicial decisions to be enforced. To these ends, USAID programs should support efforts by the courts to exert judicial independence and to act impartially and without corruption; strengthen the legislative process; increase public awareness of laws; and improve access to, and quality of, competent counsel and advocacy organizations available to the public. (Note that activities to improve enforcement are predominantly under the domain of DOJ and other agencies).

Over the next four years USAID's rule of law programs will place more emphasis on efforts to empower citizens to hold government accountable and take advantage of their political and economic rights under the law. Citizen empowerment is often the missing link between structural reforms and institution-building on the one hand, and the successful fulfillment of expected reforms on the other. Lacking strong political will, citizen empowerment is essential for advancing reforms in Ukraine. Targeted assistance to government institutions, including the courts, parliament, and Ministry of Justice, will continue, however, albeit at slightly lower levels than in the past. Support to the parliament will focus more on building its human resources capacity and fostering relationships with non-government policy and analysis centers. Support to the courts will focus more on increasing judicial independence and public confidence in the judiciary as a fair and reliable arbiter of the law. After four years, such assistance efforts should have contributed significantly to the establishment of a more independent, professional, and respected judiciary and legislature, and to the quantity of cases of citizens and NGOs successfully upholding their rights and holding government accountable to the law.

Judicial System

A well-functioning court system that garners the confidence of the citizenry is the central pillar of an effective legal system. This entails the courts fulfilling their constitutional role as an independent branch of government which depends largely on its acquiring the institutional capability to discharge its responsibilities. USAID's activities will continue to upgrade the level of juridical knowledge and skills of sitting judges and court staff, and to improve the courts' capacity to operate independently. Training, support for the new judicial training center, procurement of legal databases and other resources, and technical assistance in improving court management all contribute to strengthening judicial independence, especially given the limited budgets allocated to the courts by the government and the lingering practice of trying to influence judicial decisions. Furthermore, the pace of judicial reform has been stalled pending adoption of a law on court restructuring which is necessary to implement constitutionally-mandated changes in the judiciary by 2001. Adoption of this law, it is hoped, will clarify the roles and pave the way for further judicial reforms. USAID continues to coordinate with the Supreme Court, World Bank, and other Ukrainian and international entities involved with judicial reform.

Legislative Process

Ukraine still lacks a post-Soviet civil code, civil procedure code, and other fundamental legislation essential for economic and democratic reform, as well as certain legislation that is necessary to meet Council of Europe membership requirements. Furthermore, there are significant shortcomings in the institutions and processes for drafting, adopting, and implementing such legislation. USAID activities address these shortcomings in many ways, including, targeted support for specific legislative drafting working groups; a program to strengthen parliament's analytical and legislative drafting capabilities for more effective participation in national policy debates; training for parliamentarians and staff on specific reform topics as well as on ways to improve parliamentary rules, procedures, and structure; improving the professional capabilities of parliamentary staff; encouraging greater responsiveness to individual constituents and NGOs/citizens groups; and support to non-governmental public-policy and advocacy organizations that are attempting to influence legislation.

Accountability

At the same time that USAID is augmenting the capabilities of key government institutions involved in the creation of a Western-oriented legal system, it is also seeking to reform that system by empowering citizens who are generating pressure for adherence to the rule of law. Even the existence of an independent court system and adequate legislation would be insufficient to ensure the establishment of a rule of law-based society in Ukraine in the near future. Selective application of laws and lack of enforcement of judicial decisions result in very little accountability of corrupt and illegal actions, which

in turn reinforces citizen apathy. An active citizenry pressuring the GOU to fulfill its responsibility in establishing the rule of law is particularly important in the early stages of the formation of the legal system, and USAID will place increasing emphasis on programs that empower citizens and NGOs to have their legal rights enforced and to hold others accountable to the law. Activities to achieve this goal include support to legal advocacy NGOs, business associations, consumer and special interest groups, *pro bono* legal clinics, legal support centers for non-state media and independent trade unions, and associations of advocates (defense attorneys). This support takes the form of small grants, training, and technical assistance, as well as a successful program to publicize legal information, the availability of legal services, and successful examples of legal advocacy in the media. Yet another initiative that may be replicated is the organization of integrity-building workshops in municipalities that have active citizen groups and a certain degree of political will to address corruption issues.

Enforcement of Judicial Decisions

Without effective enforcement of laws and legal decisions there is no prospect of establishing a functioning law-based system and increasing citizen confidence in the integrity of the judiciary. In addition to the requisite political will on the part of the government to ensure compliance with the law, agencies responsible for enforcement require adequate resources and know-how to carry out their function. The US Department of Justice is integrally involved in this last endeavor and its success will help determine the fate of the entire rule of law effort in Ukraine.

❖ B. Strengthen Civil Society

The participation of well-informed citizens in political and economic decision-making is one of the foundations of democracy. Active non-governmental organizations (NGOs), an independent and unrestricted press, and free elections are all essential for citizens to make informed decisions and to participate. Such participation is essential to holding government accountable to the law and to applying pressure for further democratic and economic reforms. The main obstacles to greater citizen participation in Ukraine are: (1) lack of confidence in the political process, which leads to apathy; and (2) lack of useful and unbiased information available to citizens. USAID programs, therefore, should support efforts to increase transparency in government decision-making, programs that promote more objective and unbiased sources of news and information, and efforts by citizens and NGOs to influence the political process and uphold citizens rights. When such activities are successful, citizens' trust and confidence in the system is built, and citizens are more likely to participate.

Many of USAID's civil society programs will continue over the next four years, but with some noteworthy changes. First, as noted in the section on promoting rule of law, even more emphasis will be placed on empowering citizens, specifically with regard to their legal rights. The media and independent trade union programs, for example, will continue to place greater emphasis on legal support services, and NGO programs will

focus more on supporting NGOs that influence public policy and advocate on behalf of citizens' rights. In line with the overall Mission strategy, most civil society programs already focus most of their attention in regions outside of Kiev, and the professional level of non-state media and NGOs outside of the capital have improved noticeably over the past several years, as has the openness of government decision-making in some municipalities. Civil society programs will also coordinate closely with rule of law, local government, and other programs that will be placing greater emphasis on increasing government transparency and citizen empowerment at the local level. Election-related programs will also focus more on strengthening citizen involvement, through support for citizen watchdog groups and local-level political activists, and on legal accountability, by addressing problems associated with adjudication of electoral disputes. Technical support to the Central Election Commission and to national political parties, however, may taper off after the 1999 presidential elections in favor of greater emphasis on civic education and political activism at the local level.

Increased Confidence in the Political Process

According to public opinion surveys, fewer than 10 percent of Ukrainians believe they have sufficient legal protection to protect their rights and interests, and fewer still believe that they could do anything against a decision by the government that infringed upon the interests of the people. This low level of confidence in Ukraine's political and legal system political process contributes to the high level of public apathy. Citizens' participation should increase, however, when Ukrainians see clear examples that participating in civil society can lead to positive results. USAID will increase efforts to empower citizens and NGOs to be more effective and active participants in the economic and political processes. To this end, USAID activities will support programs that improve the legal environment for NGOs; improve the quality and availability of objective news and information programs; increase transparency in government decision-making processes and legislative drafting; support the conduct of free and fair elections; strengthen public policy and advocacy NGOs; and encourage citizens to be more involved the development of a civil society in Ukraine. Citizen participation should increase as citizens continue to learn from experience and demonstration cases that NGO and civic participation in the political process produces positive benefits, that government officials can and should be more accountable, and that democratic elections provide a regular opportunity for citizens to directly affect government policies.

More Unbiased Public Information Available to Citizens

In addition to confidence that their participation will have some impact, to participate effectively citizens must have reliable information. Their access to information requires both increased transparency on the part of the government, and more effective unbiased news coverage by the mass media. USAID programs, therefore, help ensure that citizens have access to unbiased information upon which to base their political activity by encouraging greater government transparency, increasing the availability of useful and objective information, promoting more responsible journalism, and increasing the quality

and financial viability of non-state media. As noted above, greater emphasis will be placed on protecting the rights of non-state media, through efforts to train judges, lawyers, journalists, and editors in media law (including relevant provisions of the European Convention on Human Rights), and by supporting programs that provide legal advice and services to non-state media and media watchdog groups. The effectiveness of citizen participation in Ukraine's civil society will increase as citizens take advantage of more and better information, and such changes will be self-supporting as citizens demand more from government and media having seen that they have a right to dependable and abundant sources of objective news, and that government can and should be more transparent.

❖ C. Local Government

As Ukraine continues its democratic and economic transition, local level action is essential if reforms are to succeed. If assistance in municipal development at the local government level is properly focused and directed, it is the assistance most likely to visibly impact the lives of people and have the largest positive effect on citizens' perceptions and the practice of democracy and economic reform. Changes have begun to occur in the last few years. Locally elected officials and citizens are increasingly perceiving local government as a separate and independent level of government, responsible to the citizens and not central authorities. Modifications in national law and practices have resulted in the decentralization of tariff setting responsibility, increasing responsibility for the provision of communal services (coupled with the termination of subsidies from the central level).

Particularly in the area of urban services, there is increasing citizen dissatisfaction in most communities with the poor quality, inefficiency and cost of basic services. In contrast, in some communities, such as those receiving USAID technical assistance, municipal service improvements played a positive role in the local 1998 elections. However, most officials and local administrators often lack the skills and capacity needed to administer, plan and provide quality urban services efficiently.

With the concerted efforts of USAID contractors, the Association of Ukrainian Cities (AUC), and knowledgeable Mayors, city officials and Rada deputies, new national legislation will eventually form new legal and financial frameworks that will increase local fiscal autonomy, authority and control. However, the new laws and regulations will result in increased demands on local officials, requiring additional knowledge, tools and skills. Therefore, USAID needs to be in a position, through our contractors, clients, NGOs and AUC, to be an active partner in the process of the drafting, consideration and implementation of legislation affecting local governments and intergovernmental finance reform.

The Mission strategy over the next few years will focus on: 1) democratic governance - transparency, accountability, responsiveness, citizen participation and effectiveness; 2) improved fiscal and financial management, including the development of operating and

capital budgets, financial planning, business and investment plans, and economic development plans; 3) improved management capacity and administrative practices; 4) improved municipal services delivery and tariff reform, including improvement in the quality of service and the efficiency of service provision in the areas of public transportation, heating, water/sewer, solid waste, and housing; and 5) continued strengthening of the Association of Ukrainian Cities as the lobbyist and professional association for local governments.

III. Improving Quality of Life

The foregoing discussion makes a clear case that the living conditions of most Ukrainians have deteriorated since independence. The USG assistance strategy places importance on programs that help people address their immediate needs. Programs include local-level, small-scale infrastructure support activities discussed in detail under “Local Government” and social service activities described under the section “Easing the Pain of the Transition”, among others. USAID’s approach to addressing health problems is explained below.

❖ Improve Health Care Services

Since the collapse of the Former Soviet Union, much of the old government and social structure supporting health care has become increasingly dysfunctional, while the overall risk to the health of the Ukrainian population has continued to rise. Much of the decline in health and increased risk can be attributed to lack of preventive care, disease management (infectious, degenerative, cardiovascular, circulatory, cancers and congenital/perinatal diseases), poor lifestyle choices, adverse environmental and occupational health conditions, and accidents.

The effectiveness of Ukraine’s health care system is hampered by a continuing practice of funding and allotments based on hospital bed occupancy; weak financial management; emphasis on specialists and tertiary care; insufficient attention to preventive medicine and/or early detection and treatment by primary care practitioners; and lack of materials and information.

Shifting emphasis to efforts to adopt primary care as a basis for more efficient, cost-effective, and higher level of health care delivery will form the basis of USAID’s strategy in health. Primary care emphasizes wellness, prevention and first-line care, improving health and reducing dependency on specialized health professionals, expensive equipment and procedures, and lengthy hospital stays. Assistance programs will foster a more efficient primary health care delivery system; promote healthy lifestyles; provide health services education and training; develop rational pharmaceutical management and health management information systems; improve approaches for sustainable financing; advocate health policy changes; and improve environmental and occupational health.

USAID will help enhance health care delivery by building on previous initiatives to demonstrate the value of primary care as the foundation for health care delivery in Ukraine. We will work with the Government to develop models for system restructuring and enhancement of family medicine through demonstration sites.

We will work towards the promotion of healthy lifestyles emphasizing "health" rather than "illness" and "prevention" rather than "treatment." Selected unhealthy lifestyle choices, such as alcohol and drug abuse, poor nutrition, smoking, lack of exercise,

insufficient prenatal care, sexually irresponsible behavior, violence against women and children, and a paucity of mental health treatment options will be addressed through various outreach programs.

Assistance programs will also recognize environmental and occupational health issues related to the protection of the population. Ukraine is making progress toward developing its National Environmental Health Action Plan, which will identify priority areas where action is needed to reduce exposures or to take remedial actions to mitigate contaminated releases. Identified priorities will require the creation of stronger linkages between local control and health authorities to overcome negative health impacts of exposure.

To date, health care financing demonstration projects have worked with local policy makers to design and implement financing mechanisms to supplement inadequate budgets. They have taught budgeting and management skills, as well as introduced user fees for some medical services. Programs that assist in stabilizing government funding and introducing other revenue mechanisms to support the health care system will be continued.

Working at various levels of government, but particularly at the local level, USAID efforts will continue to help the appropriate government organizations establish health care legislation and policies that support implementation of an effective health care system. This will include modifying or altering policies on, and implementation of, standard practice protocols, decentralization, health care financing and payment, quality assurance, monitoring, and standards.

The number of primary care sites in operation will define progress. The largest obstacles we foresee would be in influencing and changing legislation/policy at the national level. Some of these problems have been and can continue to be circumvented by working primarily at the oblast level, where decisions are often made without national level involvement. A renewed emphasis will be made at the national level as well in an effort to maintain parallel tracks between national policy change and implementation. Although not anticipated, if this is not successful, work will be contained at the local level.

IV. Global/Special Issues

❖ A. Global Warming

Ukraine is among the ten largest carbon emitters in the world, largely because of gross inefficiencies in energy production and consumption. Industry and electric power generation account for approximately 75 percent of Ukraine's CO₂ emissions from commercial energy consumption while the residential sector accounts for 14 percent.

Ukraine has been identified as one of nine key countries that are, or will become, significant contributors to greenhouse gas emissions. Though the CO₂ emissions of 13 tons per capita in 1995 were below the 1990 levels of 14.3 tons per capita, this decline was more the result of decreased industrial production than an increase in energy efficiency. As the economy makes progress on its transition to a market economy and economic activity resumes and accelerates, CO₂ emissions are expected to increase.

Burning of fossil fuels either for the production of electricity or industry is responsible for 85 per cent of carbon dioxide emissions, the major component of the greenhouse gases that cause global warming. In Ukraine electrical energy and heat use is extremely inefficient, primarily in the industrial and municipal sectors. Extensive implementation of energy efficiency measures could address a wide range of Ukraine's economic and environmental problems to improving overall economic competitiveness and reducing pollution.

Moreover, because Ukraine's CO₂ emissions are currently below 1990 levels, Ukraine qualifies as a potential seller of carbon credits to international investors who may wish to offset carbon liabilities elsewhere.

USAID proposes to support Ukraine's participation in the UNFCCC by creating a collaborative process through which the combined efforts of governments, the private sector, and non-governmental organizations can be focused on promoting market-based transfer of environmentally sound technologies and infrastructure. The USG proposes a strategy that encompasses two phases.

Phase I. In this phase, the USG will work with the Government of Ukraine to establish legislative, regulatory, and market structures, and the local institutional capacity to participate in emissions trading regimes. This includes monitoring, verification, and certification of CO₂ net emissions and project baselines, as called for under the Kyoto Protocol. The significant result of this phase will be the creation of this institutional capacity. Signing of a bilateral agreement between the US and Ukraine on a Joint Implementation Program could also take place.

USAID may continue to build on its existing electric utility partnership program. This program stimulates partnerships with energy-intensive and progressive industries (chemical, steel, pulp and paper, automobiles and agriculture). It partners private firms with counterparts in Ukraine for increasing productivity and environmental soundness through improvements in management, production processes and technologies.

Phase II. During this phase, USAID will start to facilitate public- private partnerships that transfer environmentally sound technologies through investment and mitigate the impact of greenhouse gas emissions. USAID may build on the work that it has done under pilot projects and seek partnerships with international electric utilities and equipment manufacturers.

❖ B. Kharkiv Initiative

After the Turboatom Company in Kharkiv agreed not to produce nuclear turbines for Iran at the request of the USG, Secretary of State M. Albright announced the Kharkiv Initiative to foster development in Kharkiv. The Initiative's goal is to create a positive environment for investment in Kharkiv, and create an overall increase in income and employment for Kharkiv citizens.

The USG is exploring ways to provide targeted assistance to help achieve these aims. To that end, the USG is currently working on a Strategy for its assistance to Kharkiv. The Strategy document to be prepared will lay out a set of recommendations to improve the investment climate in Kharkiv, taking into account the income and employment gains possible under each of the recommendations. The Strategy will cover a period of five to ten years, recognizing that USG assistance (specifically for the Kharkiv Initiative) after year five should be nearly completed. The Kharkiv strategy document will assess the current economic situation in Kharkiv, including economic, business, and local level government constraints.

❖ C. Anti-Corruption

As reported in a recent study by Transparency International (among other studies), Ukraine ranks among the most corrupt countries in the world. Corruption in Ukraine is endemic. Corruption exists in political as well as economic spheres, and in the private as well as public sector. It ranges from petty corruption to grand corruption, and includes isolated incidents between individuals as well as systemic corruption involving organized crime. Efforts to reduce corruption, therefore, must be incorporated into a wide range of activities that will require broad coordination among USG agencies and departments. Many anti-corruption efforts will be addressed within existing programs, where our assistance promotes efforts to adopt and enact legislation, and procedures and practices that decrease opportunities for corruption and increase transparency within government bodies and sectors of the economy. Other anti-corruption efforts can address corruption directly, including efforts to improve enforcement mechanisms, as well as to change public perceptions about corruption.

Because corruption exists in virtually every sphere in which the USG provides assistance, the issue needs to be considered in all of our assistance programs. For example, USG programs in Ukraine have helped foster more transparency in capital markets and the banking sector; assisted with the drafting of laws governing investment funds; worked with the Ministry of Finance to implement better financial management practices; assisted the State Tax Administration to improve and modernize tax collection procedures and encourage sounder tax policies; developed business advocacy groups that lobby municipal governments to enact laws and policies that provide a less corrupt environment for business development; supported the drafting and adoption of ethics codes in the government and in professional associations; encouraged municipal governments to adopt more transparent practices; sponsored educational programs to inform citizens and businesses of their legal rights; supported successful efforts by advocacy organizations to hold government officials accountable to the law; secured

adoption of an amendment to a law reducing the number of business licenses from 102 to 41; supported the creation of an Auction Center Network which sets procedures for privatization certificate distribution and collection; promoted GOU accountability by monitoring local and regional government interference with the movement of grain and other commodities; and provided training for government officials, lawyers, judges, bankers, journalists, civic activists, entrepreneurs, and others on topics designed to reduce corruption by increasing transparency and accountability.

The U.S. assistance program will continue to incorporate anti-corruption measures such as those described above into virtually every ongoing activity. But anti-corruption components must be more proactive and holistic in approach. Certainly there will be problems that are too difficult to overcome. For example, low level bureaucrats and other government employees who are underpaid and/or owed back wages are less likely to refrain from corrupt practices when such practices account for the bulk of their income. Nonetheless, it is unacceptable to brush aside corruption as 'inevitable.'

In general, corruption will be addressed by: (1) improving the legal and regulatory framework, and (2) supporting incentives for adherence to the legal and regulatory framework and creating disincentives for practicing corruption. In the first category, the U.S. assistance program will assist with drafting new legislation, amending existing legislation, implementing new regulatory policies, establishing oversight and watchdog mechanisms, promoting codes of conduct, and providing training related to the new legal and regulatory framework. In the second category, the USG should identify and collaborate with the stakeholders who have the most to gain from reducing corrupt practices in their areas of concern, and support these groups/individuals. Such support may come in the form of training, supporting advocacy organizations, publicizing examples of corrupt practices and/or examples of efforts to reduce corruption, or raising corruption issues at high level meetings on behalf of the identified stakeholders.

In addition to addressing corruption within sectors in which we provide assistance, the USG will support programs designed to address corruption directly. Specific anti-corruption programs include (1) enhanced law enforcement, (2) broad based anti-corruption campaigns, and (3) changing public attitudes about corruption. The first category will not be discussed in this paper as it falls outside USAID's scope. It should also be noted that all of the activities described below will require close cooperation with other US agencies and departments.

President Kuchma's governments have initiated several broad-based anti-corruption programs since 1994, the most recent of which being a seven-year plan adopted in early 1998. These programs have most often been greeted with a large amount of skepticism, and, arguably, have had limited success in reducing corruption. The World Bank sponsored conferences in 1997 with the purpose of supporting national efforts to implement anti-corruption programs, but again, the political will to carry through on such programs was lacking. At the local level, however, there is often more political will, and consequently, more opportunities for successfully implementing broad anti-corruption

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programs. By bringing together local government officials, businesses, professional associations, civic groups, and media, it is often possible to identify practical measures to reduce corruption at the local level. Whereas political will may be lacking for such measures at the national level, local leaders sometimes have more to gain by reducing corrupt practices that impede service delivery, hinder economic growth, and foster discontent among the electorate.

Public perceptions about corrupt practices can also be influenced, albeit over a much longer term. The USG will, however, support programs that increase citizen demands for transparency and accountability. According to a poll by the Democratic Initiatives Foundation conducted annually since 1996, less than 6 percent of the population believes that it could do anything against a government decision that infringes upon the interests of the people. The same polls show that only 7 percent of the population feels that legal protections defending their rights and interests are sufficiently present in their lives. Informing people of their rights, supporting efforts to have those rights upheld, and publicizing examples of successful cases of citizens defending their rights, therefore, is likely to generate greater expectations among citizens that corrupt officials should be accountable under the law. The USG will operate programs that support indigenous efforts to (1) inform people of their specific rights in various situations, (2) advocate on behalf of citizens and businesses to have those rights upheld, and (3) widely disseminate, primarily through TV, programs highlighting successful cases.

❖ D. Combating Trafficking in Women

In response to the escalating problem of sexual trafficking of women in Ukraine, as well as a growing interest among government officials and non-governmental organizations to halt this problem, the U.S. has launched a major anti-trafficking initiative. Working closely with Ukrainian counterparts and indigenous women's groups, participating USG agencies have developed a multi-pronged strategy -- in line with President Clinton's 1998 Executive Memorandum -- which works to prevent potential victims from being trafficked, protecting women who are, and prosecuting those responsible for this crime.

As economic conditions have deteriorated in Ukraine, a growing number of unemployed and under-employed women, many with high levels of education, have sought financial opportunities abroad. Following promises of a lucrative job in a foreign country, some women arrive at their destination only to find themselves forced into prostitution through coercion or violence. The Ukrainian Government estimates that thousands of women have been trafficked to Western Europe and elsewhere, almost always by organized crime outfits, to enter the sex trade.

The Anti-Trafficking Initiative is an array of inter-related activities aimed at addressing the prevention, protection, and prosecution components of the problem. The first prong of the Initiative -- prevention -- has received the greatest emphasis by USAID. Within its framework are numerous activities designed to reach the most at-risk women who are

deemed especially susceptible to the allure of overseas employment. Working through print and broadcast media, secondary schools, and existing NGOs and community groups, USAID and the Department of State are supporting programs that inform potential victims about sexual trafficking and its inherent dangers.

The second component of the strategy -- protection -- revolves around the provision of services to potential and actual victims of trafficking. Through the Trafficking Protection Centers (located in Donetsk, Dnipropetrovsk, and Lviv), women can access legal services and information, as well as references for free medical and counseling services. These health services will be provided through an existing network of indigenous organizations, as well as the USAID-funded Community Health Partnerships Program and Women's Wellness Centers. It is anticipated that both programs will incorporate a training activity for health care providers to heighten awareness about domestic violence and trafficking cases, as well as treatment methods. These health centers will also serve as a referral service for women who need additional support that can be provided through NGOs or specialized organizations.

The third dimension of the anti-trafficking initiative -- prosecution -- centers on effective enforcement of existing laws that ban this exploitative practice. Recruiting women into the trafficking network, and moving them across international borders, requires considerable organizational capacity. This lucrative business is largely run by organized crime entities. The U.S. Department of Justice, FBI, and the Department of State are working with their Ukrainian counterparts on these legal aspects of the trafficking issue.

As part of its anti-trafficking strategy, USAID is developing a data collection/analysis and performance monitoring plan. To date, the Mission has established performance indicators and set preliminary targets to gauge progress in reducing sexual trafficking. Working through existing sources and information acquired by the DOS/IOM public information effort, USAID and its implementing partners will continue to gather crucial data on the nature of the problem and use this information to refine the Initiative as it proceeds.

❖ E. Poland – America – Ukraine Cooperation Initiative (PAUCI)

In an effort to strengthen further the emerging cooperative relationship between Ukraine and Poland and to take advantage of acquired expertise and lessons learned in Poland as a result of its success in consolidating the transition to free-market democracy, the U.S. has launched a trilateral initiative to foster programmatic linkages between the two former communist countries. By helping to multiply and deepen state-to-state and society-to-society ties between Poland and Ukraine, PAUCI (Poland, America, Ukraine Cooperation Initiative) seeks not only to accelerate Ukraine's transition away from Soviet-era central planning toward a robust market-based system, but also to anchor Ukraine more firmly in the new Europe, of which Poland is rapidly becoming an important part. A democratic

and economically prosperous Ukraine is a powerful force for stability on the European continent.

In a broader context, this initiative will also help Ukraine with European integration, as it will foster closer cooperation not only with Poland, but with countries that have been designated membership in the EU, such as Estonia, Slovenia, the Czech Republic, and Hungary. It will allow Ukraine to draw from the experience of not only Poland, but also other Central European nations and learn valuable lessons in European integration.

As presently conceived, the USAID-funded component of the Poland-America-Ukraine Cooperation Initiative (PAUCI) will focus on three areas: macro-economic policy reform, small business development, and local government reform -- all viewed as critical to improving citizen's lives and to advancing the reform process more generally. The latter will involve efforts to strengthen civil society primarily through work with non-governmental organizations (NGOs) and local governments, while Polish NGOs will also be instrumental in work to bolster Ukraine's nascent small business sector. Poland's impressive progress in building a stable democratic political order and establishing a market-based system that has spawned economic growth offers a wealth of relevant lessons for a country such as Ukraine still struggling to overcome the legacy of communist central rule.

Prognosis

The situation in Ukraine four years from now cannot be determined with any certainty, given the risks and the lack of any upward trend. Turning points are notoriously difficult to project, but the USG is proposing this strategy in the expectation that the economy will stop its decline and start to improve, along with the quality of life and the civil society, due in part to the proposed program. This program will help to develop and strengthen the institutions needed for a viable, private sector economy to thrive. Private investment will be needed to bring about economic growth, but it will not occur without major improvements in the investment climate that this program will make possible. Programs in the key sectors of energy and agriculture are needed to facilitate the transition to private sector control and operation.

Four years is too short a time to bring about all the needed changes. The previous seven years have seen departures from the Soviet model, but many of these changes have not been helpful in bringing about the transition to the private sector-led economy that is necessary to raise incomes and improve the quality of life. Nevertheless, it is possible to make a reasonably informed forecast of the situation in 2002, if reasonable progress is made in the proposed program. Economic growth will have started to occur, but the rate will be low given the continued contraction of some parts of the economy. For example, the IMF projects that if its program is followed, GDP growth could rise to 1 percent in 2000, 3 percent in 2001 and 4 percent in 2002. But more important than the rate of

growth is the upward direction based on a solid foundation of institutions. This is where USAID can make a difference as by far the largest donor in terms of technical assistance.

Gaps in Strategy?

The assistance strategy attempts to improve the policy environment in economic restructuring, democratic change process, and social issues, and the longer-term needs by supporting sub-national groups (e.g., NGOs) in developing voices for change. In an earlier section this document highlights the education system as a major obstacle to further change. A reformed educational system teaching democratic values would prepare the people to function in a modern society.

Although school enrollment rates and literacy are generally high, and the university-enrollment rate is among the highest in Europe, schools and universities still turn out “soviet” thinkers. The entire system needs reform from re-teaching the teachers, to transforming the curricula. Translating Western books into Ukrainian and introducing them into schools, positive steps forward, only touch on the problem. However, the donor community has been frustrated by an education ministry that strongly defends its present system and singles out lack of funding as the principal problem in its school system. Until there is receptivity to change, no donor organization in Ukraine will involve itself in this quagmire.

However, this raises an issue for all of the USG assistance programs across the NIS. Little recognition of the education problem was given in earlier strategies. With major donors reassessing their strategies and programs, we expect education reform will be given greater attention in the future.